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SUBJECT: INDONESIA - SLOW PROGRESS ON INVESTMENT REFORMS

REF A) Jakarta 3563 (GOI Unveils Investment Package)
B) Jakarta 2315 (GOI Readies Investment Package)
C) Jakarta 5420 (Tax, Customs Chiefs Replaced)
D) Jakarta 5704 (GOI/Unions Assign Blame)
E) Jakarta 4465 (Worker Protests Against Labor Law)

11. (SBU) Summary: The Government of Indonesia (GOI), led by Coordinating Minister for the Economy Boediono, continues to move ahead with the broad array of reforms outlined in its February 27 investment climate policy package. Parliament held hearings on the GOI's draft investment law (Ref A) on June 7 and June 23, but has raised many of the same contentious issues that delayed the GOI's finalization of the draft law for over a year. In a development that cheered the business community, Finance Minister Sri Mulyani removed the powerful and seemingly untouchable Director Generals for Taxation and Customs on April 21 (Ref C), paving the way for an agreement between the GOI and the business community on revisions to a package of controversial tax law amendments pending in Parliament. Employers and some labor groups are gently exploring ways forward on revisions to Indonesia's restrictive labor law after mass demonstrations in May led the GOI to back down from its plan to submit comprehensive revisions to the law. Some of the less sweeping measures in the investment package are also bearing fruit: business contacts say the GOI has reduced the time needed to start a business and clear goods through customs. Although keeping implementation of the 85 measures in the package on schedule will be a major challenge, senior GOI officials hope a private-public "external monitoring group" will exert effective pressure on mid-level bureaucrats to achieve results. End Summary

12. (SBU) The GOI, led by Coordinating Minister for the Economy Boediono, is moving ahead with a package of reforms designed to make Indonesia's economy more friendly to foreign and domestic investors. The reform package, contained in Presidential Decree 3/2006, tracks closely with the recommendations of an Indonesian Chamber of Commerce and Industry (Kadin) "roadmap" for improving the business environment and a Consultative Group of Indonesia (CGI) paper outlining high priority policy areas. Most of the package's 85 outputs are revised decrees, regulations, or draft laws, making it difficult to gauge the real-world impact of the measures. Nonetheless, there has been significant progress on three of package's four cornerstones

-- the enactment of new investment, tax and customs laws -- which, if completed, would be a significant boost to the investment climate. Progress on amending Indonesia's restrictive labor laws has proven much more difficult, but neither the GOI nor Kadin are ready to give up yet.

Parliament Begins Consideration of Investment Law

13. (SBU) After a year of jockeying between Minister of Trade Mari Pangestu and Investment Coordinating Board (BKPM) Chairman Muhammed Lutfi, the GOI finalized its draft investment law and submitted it Parliament on March 21. The draft law would replace separate laws for domestic and foreign direct investment and create equal treatment of both. It would also codify a number of international investment principles including unrestricted repatriation of profits and capital, rules and compensation for expropriations, a clear and concise negatives list, and removal of limits on investments and forced divestments. The GOI intentionally left the language of the draft law very general in order to allow it the flexibility to address a number of contentious issues through separate implementing regulations. Pangestu has stated the GOI intends to issue the regulations at the same time Parliament passes the investment law, and the World Bank is providing technical assistance. Forthcoming regulations include:

--Two Presidential Decrees listing sectors closed to foreign investment (negative list) and open to investment with conditions. Pangestu told the CGI on June 14 that the list will be clearly defined using SITC codes and linked to Indonesia's national interests (i.e. not solely driven by

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demands by specific sectors for protection).

--A decree spelling out the provision of integrated registration and licensing procedures by regional governments for investors.

--A list of tax and other incentives available for investors as well as procedures for applying for them.

--A decree outlining the role and functions of a restructured BKPM, emphasizing its role as an investment promotion body.

--A decree streamlining the investment process.

14. (SBU) The most controversial issue has been the GOI's stated intention to shift the GOI's investment regime from an approval to a registration system by stripping the BKPM's approval authority and turning it into an investment promotion body, reforms Lutfi has strongly resisted. While Pangestu may have prevailed in her scuffle with Lutfi, the battle over the fate of the BKPM and other challenging issues could continue in Parliament. Parliament's Commission VI held its first hearing on the proposed law on June 7, during which Pangestu fielded a wide range of concerns from representatives of major political parties. These included the future role of the BKPM in investment policy and approvals, the absence of a clear negative list and non-tax investment incentives, and the wisdom of including provisions for national treatment and unrestricted repatriation of profits and capital. At a subsequent June 23 hearing, Pangestu responded to comments from Commission VI members, emphasizing that the GOI produced the draft law after inter-agency discussion and that both the Ministry of Industry and BKPM participate in the committee that drafted the law and will prepare the regulations.

GOI Resubmits Draft Tax Laws to Parliament

15. (SBU) After less than five months on the job, Finance

Minister Sri Mulyani replaced her notoriously corrupt and seemingly "untouchable" Director General of Taxation Hadi Purnomo on April 27, who had served under three Presidents and five finance ministers. Mulyani also replace Director General of Customs Edy Abdurrahman. The move cheered the business community, which has long viewed corruption and inefficiency at the two agencies as glaring examples of Indonesia's poor business climate. The new DG for Taxation, Darmin Nasution, is taking an active role in modernizing tax administration, reforming internal procedures, and making the tax service more customer friendly.

¶6. (SBU) Purnomo was responsible for sabotaging months of GOI and private sector consultation to produce amendments to Indonesia's income tax, value added tax and luxury tax, and taxation procedures laws (Laws 17/2000, 18/2000, and 16/2000 respectively). The amendments aimed to strike a better balance between taxpayer rights and protections and tax office authority, but business community displeasure with the final package led Parliament to delay consideration of the amendments until 2007. As one of its first investment policy reform tasks, the GOI in March decided to recall Purnomo's amendments from Parliament and discuss revisions to them with the Indonesian Chamber of Commerce (KADIN). The GOI then, on June 5, submitted its latest drafts to Parliament.

¶7. (U) According to a World Bank report, the new amendments would allow taxpayers to be present during audits and view their results, pay only their own self-assessment during appeals (instead of the disputed amount), face administrative rather than criminal sanctions for first time violations, and enjoy some safeguards if tax authorities freeze their assets. The amendments would also cut the statutory limit for tax assessments from ten to five years, extend filing deadlines for corporate income tax filers, allow automatic extensions, and remove the requirement that every refund request first undergo an audit. They would

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also drop a GOI plan to make mutual fund dividends taxable, reduce the corporate tax rate to 28 percent immediately and to 25 percent by 2010, and cut taxes on dividends. Low income earners would also face lower taxes, and minimum wage earners would be exempt from taxes altogether. The draft VAT law amendments would exempt unprocessed agriculture products, electricity and water.

Parliament Helps Improve Customs Law

¶8. (SBU) The GOI submitted a draft customs law to Parliament in September 2005 that focuses largely on combating smuggling, under-invoicing, and customs fraud by imposing harsher penalties and fines and greater authorities for customs officials. Critics of the draft complain that by expanding the authority of customs officers, it will encourage even greater rent-seeking behavior while doing little to improve the efficiency of customs processing. On this issue, Parliament may be playing a constructive role. Ministry of Finance officials are holding weekly closed-door meetings with a special Parliament committee to consider revisions to the draft law. According to contacts at Customs, these discussions have focused on implementation of a customs single window and other measures to speed up customs processing, as well as a more clearly defined list of restricted products.

Labor Law Revisions Remain in Limbo

¶9. (U) The GOI made labor law reform one of its highest priorities for 2006, with emphasis on reducing Indonesia's relatively high severance payments and tough restrictions on outsourcing and contract workers. According to a World Bank report, the GOI's draft law would reduce the average

severance pay from nine to seven months, length of service pay from 19 to six months, and remove distinctions between severance levels for dismissals with cause and those due to economic factors. The draft law would also permit employers to use fixed-term contracts for all work activities for up to five years, and permit the expansion of outsourcing.

¶10. (SBU) The GOI worked closely with the Indonesian Employers Association (APINDO) in formulating the drafts, but failed to properly consult labor. The labor movement, which initially seemed somewhat amenable to a more competitive labor law held a series of demonstrations in April and May, including one on May 3 that ended in a minor riot in front of the Parliament. Shortly after the demonstrations, President Yudhoyono announced the GOI would drop its plan to submit the draft law to Parliament in the near future and would instead create a group with representatives from five universities to study the issue further. The protests also prompted House of Representatives Speaker and Golkar Deputy Chairman Agung Laksono on June 2 to officially request that the GOI abandon its plans to amend the labor law.

¶11. (SBU) Since the May demonstrations, APINDO Chairman Sofjan Wanandi has held discussions with the Confederation of Indonesian Prosperous Trade Unions (KSBSI), and both parties have agreed to hold a "national bipartite summit" that would include employers, unions and academics towards in late June. Wanandi tells us he is upbeat about the process and still optimistic about the possibility of seeing new labor laws (or more likely regulations) enacted by the end of the year. However, the Confederation of All-Indonesian Workers' Union (KSPSI) and other labor federations have yet to agree to the proposed June bipartite meeting.

Some Reforms Already Having an Impact

¶12. (U) Some reforms are already having an impact. A World Bank consultant who is closely monitoring the investment climate reforms has told us the Ministry of Justice's (MOJ) implementation of an electronic business registration filing

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and notification system has reduced the number of days needed to register a company from 45 to 21 days. The MOJ hopes to further reduce this figure to just ten days by fully decentralizing the registration process to its district offices. This could turn out to cause new delays, however, as most MOJ district offices lack computer equipment and training to run their own on-line registration programs. In addition, the Ministry of Manpower and Transmigration has simplified procedures for obtaining expatriate work permits, cutting the process from seven to four days, and extended their validity from one to two years.

¶13. (SBU) Other reforms, however, may not be having the desired effect. The Ministry of Trade has taken credit for streamlining the issuance of eight types of business licenses, including the "business trading license" or SIUP most companies operating in Indonesia are required to obtain. However, the World Bank consultant told us that Minister of Trade Mari Pangestu blew up at her staff after learning that she had approved new regulations for SIUP applications that actually expanded their coverage and reporting requirements.

Government Sets Up Monitoring Bodies

¶14. (SBU) Although the Coordinating Minister for the Economy has spearheaded the GOI's investment climate reforms, it has very limited authority over the 16 line ministries it oversees. Minister of Trade Mari Pangestu and Minister of

Finance Sri Mulyani are preoccupied with difficult reform agendas inside their ministries. The result is that the GOI-wide effort to monitor the progress and content of the 85 measures in the package remains weak, despite the fact that the package was issued under cover of a Presidential Instruction, one of the highest forms of GOI regulations. The Coordinating Ministry's strategy for overcoming its own institutional weakness has been to establish a private-public "external monitoring group", led by respected economist Faisal Basri, to put private sector pressure on the GOI to perform. But monitoring the many items in the package is a very large task, and the group is struggling to organize itself effectively in the absence of GOI budget support. The World Bank has agreed to support the group with both operating costs and technical assistance.

Comment: Implementation is Key

¶15. (SBU) GOI missteps, particularly on the draft labor law, have resulted in setbacks in key areas of the reform process. But the business community remains optimistic, if impatient, and still hopes that the GOI will complete most of its ambitions investment climate reforms on schedule by year's end. The battleground on the most significant reforms has largely shifted to Parliament, where nationalist sentiments and opposition politics are certain to be significant hurdles. Much may depend on whether Vice President and Golkar Party Chairman Yusuf Kalla throws his political weight behind passage of the four proposed laws in Parliament. The challenge on the smaller items in the package will be to keep pressure on the entrenched bureaucracy through the monitoring group, the CGI process, and other business interventions.

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